First National City Bank
Monthly Letter

Business and Economic Conditions

1960

New York, November 1960

General Business Conditions

THE business news of the past month tends to confirm that the sideways movement which lasted until late summer is giving way to a moderate downturn. Whether the phase of the business cycle in which we now find ourselves is labeled a readjustment or a recession is not very important. In any case the slackening is mild. There has been no recession in the material welfare of the American people; per capita disposable personal income in real terms touched the highest level in history in the third quarter. Similarly, expenditures on goods and services for final use by consumers, business, and government continued to rise during the quarter and promise to remain strong. However, the cessation of inventory accumulation has shifted the over-all balance of the economy from expansion to contraction.

The cutback in goods going into inventory was instrumental in reducing industrial production 2½ per cent between July and September, and probably somewhat further in October. Adding to the uncertainty have been the failure of retail sales to show the expected fall upturn and the drop in housing starts in September. The disappointing performance of profits, reported elsewhere in this issue, presages a weakening of investment in new plant and equipment.

Nothing in current developments contradicts the earlier expectation that the American economy would set new records of performance in 1960. Most comprehensive measures of business activity will reach new peaks for the year as a whole. Nevertheless, disappointment is widespread. In anticipation of a strong catch-up period after the steel strike, and of crossing the threshold into the "Sizzling Sixties," sales budgets, production schedules, and earnings expectations were simply set too high at the beginning of the year. The disparity between production and consumption, revealed as time went on in declining order backlogs and accumulated inventories, imposed the necessity for adjustments now under way.

Contraction in Industrial Output

Industrial production, as measured by the Federal Reserve index (seasonally adjusted, 1957 = 100), fluctuated within the narrow range of 109-111 from December 1959 through July 1960 – a period in which rising activity in some lines offset major adjustments in others. But in August, activity dropped below this range to 108 (revised from 109), and a further decline to 107 was estimated for September. This brought the index 4 points below the January peak.

An analysis of the record of industrial production so far in 1960 shows contraction in durable goods industries (almost entirely due to the drop in steel output) offset through June by rising activity in nondurable goods manufacturing. In more recent months both nondurable and durable goods industries have failed to achieve normal seasonal increases in order inflows and production.

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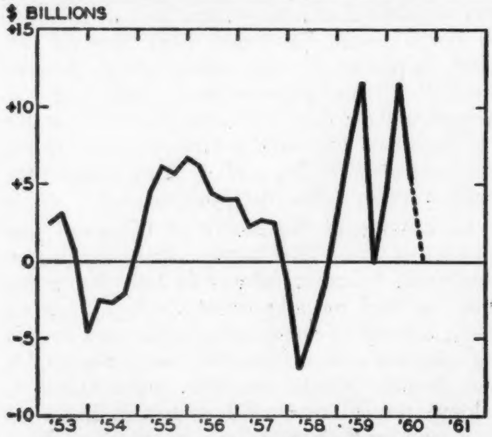
Final Demand Still Rising

The tone for business in the third quarter — slightly weaker but still basically strong — was typified by the most comprehensive of economic measures, the gross national product (GNP). Preliminary estimates by the Council of Economic Advisers indicate that GNP eased during the third quarter to a seasonally adjusted annual rate of $503 billion, down $2 billion from the record second quarter. In such a series, where revisions are large and frequent, a decline of only 0.4 per cent may not be statistically significant. Later revisions may lessen the decline or wipe it out. But the story these estimates tell is that for the moment the expansion has run out of steam.

The chief factor constricting demand in the third quarter, just as in the previous quarter, was the declining rate of inventory accumulation. After building stocks at a peak rate of $11.4 billion a year during the first quarter, businessmen tightened up on their buying and cut the rate of accumulation to $5.3 billion in the second quarter. In the third quarter there was no net change in inventories; in effect, the demand for goods from this source was reduced by $5.3 billion.

The way in which inventory demand has jumped up and down in the past three years is illustrated by the chart. It shows more than anything the whipsawing effect of the 1959 steel strike on general economic activity: the anticipatory accumulation, the forced liquidation during the strike, aggressive replenishment afterwards, and now a second phase of liquidation.

Yet the underlying fact is that, ever since early 1958, final demand — purchases of goods and services by consumers and government and capital investment by business — has risen continuously. During the third quarter the sustained strength of final demand was demonstrated by a $3.3 billion increase over the preceding quarter. Major factors in this advance were consumer services (up $2.1 billion), government spending (up $1.9 billion), and net exports (up $1.5 billion). Government outlays increased largely because of wage increases to federal employes and the stepped-up tempo of the highway program. The increased rate of defense procurement during the summer will not show up in federal expenditures for some time, but business activity and inventory policies are likely to feel some effect before long. The strength of export demand has led to expectations that 1960 will show the best trade balance since 1949, except for the period of the Suez crisis.



Quarterly Changes in Business Inventories
(Seasonally adjusted annual rates)

Partially offsetting these third quarter gains was reduced consumer demand for goods — both durable (down $2.0 billion) and nondurable (off $0.5 billion) — and for housing (off $0.3 billion). These declines were surprising in view of the steady rise in personal income to a new record of $408 billion in the third quarter, up $3.8 billion from the second quarter. Much of the decline in durables came from lagging new car sales during the summer. In October, however, a spurt of buying indicated a favorable reception of 1961 models. Retailers generally have been confident of a good fourth quarter, including a record Christmas season.

Supporting Factors in the Downturn

In light of precedent and experience, it seems probable that the downward adjustment of production and business spending will cut into buying power somewhat. But the reasons for expecting a downturn to be mild appear compelling and encouraging.

Foremost among these reasons is the rolling character of the readjustment so far. Adjustments in the various industries are not being concentrated in a single period of time but are being spread out. The fact that steel inventories are down to low levels may bring some improvement in steel mill operations, supporting the general level of activity while other industries are cutting back.

Second is the continued operation of the influences which tend to maintain income and purchasing power — the so-called automatic stabilizers, such as unemployment insurance and pension benefits. In each previous postwar recession these stabilizers have helped substantially in maintaining final demand and providing an anchor against cumulative spirals. Other types of government spending are also expected to increase.

Other factors include the greater availability of money for mortgages and business loans. On October 26, the Federal Reserve Board announced that $1.3 billion will be freed from required cash reserves of member banks to ensure ample supply of funds as the economy enters the peak season of rising cash and credit needs.

Finally, the steady pull of long-run dynamic influences will make itself felt. The vast expenditures on research and development pour out new products and new methods — and require continued heavy capital expenditures to introduce them into everyday use. The spurt in family formation and population anticipated for the late 1960s will cast encouraging shadows before as business prepares for growing markets. The disappointments of the year 1960 should not lead us to discard our optimistic expectations for the decade of the '60s.

Third Quarter Corporate Earnings

Although doing more business and handling more money in the aggregate than ever before, American corporations this year have been facing a difficult challenge in maintaining their profit margins. In a new era of intensified domestic and international competition, which has denied opportunity for price increases and led to at least spotty price weaknesses, efforts have been required to shave controllable expenses in every possible way. Nevertheless, uncontrollable elements of cost, principally employment costs, in company with failure of sales to reach higher levels, have trenched upon corporate net earnings. When profits are related to sales, and examined on a quarter-to-quarter basis, a slow but sure erosion of margins becomes apparent.

This at least is the picture that emerges from our tabulation of results of 764 corporations which, as we go to press, have released their figures for the September quarter. This group of companies, mainly manufacturing firms, shows combined net income after taxes of $2.7 billion, a decrease of 11 per cent from the preceding quarter but a gain of 8 per cent over the strike-depressed period a year ago. This brought profits for the reporting companies in the first nine months to $9.1 billion, 2 per cent below earnings for the corresponding period of 1959.

A similar trend marked the performance of manufacturing companies alone. Reports of 570 manufacturers show that third quarter profits were down 12 per cent from the June quarter and up 8 per cent from the 1959 third quarter when the steel industry was thrown into red ink as a result of the strike shutdown. Excluding steel, manufacturers' earnings actually fell 4 per cent from a year ago. For the year to date, manufacturers' earnings now trail the year-ago period by 3 per cent.

The squeeze on manufacturers' profit margins evident in preceding months continued in the third quarter. Margins narrowed from 6.5 cents per sales dollar in the first quarter to 6.2 cents in the second and to 5.4 cents in the third. For the year to date, margins have now fallen to 6.1 cents per sales dollar from 6.5 cents in 1959. The figure for 1959, hurt by the steel strike with

NET INCOME OF LEADING CORPORATIONS FOR THE THIRD QUARTER AND FIRST NINE MONTHS

(In Millions of Dollars*)

		Reported Net Income			% Change from		Reported Net Income First Nine Months		
No. of Cos.	Industry Groups	Third Qr. 1959	Second Qr. 1960	Third Qr. 1960	Third Qr. 1959	Second Qr. 1960	1959	1960	Per Cent Change
35	Food prod. & beverages	$ 84.6	$ 85.4	$ 88.4	+ 4	+ 3	$ 241.3	$ 252.8	+ 5
10	Tobacco products	67.0	64.4	66.7	—....†	+ 4	183.0	187.5	+ 2
35	Textiles & apparel	29.9	23.8	18.0	—40	—24	85.9	65.9	—23
6	Tires, rubber products	23.1	23.1	18.5	—20	—20	74.6	67.6	— 9
30	Paper & allied products	55.8	57.1	49.7	—11	—13	162.9	159.1	— 2
29	Chemical products	220.2	239.7	192.0	—13	—20	694.7	649.4	— 7
33	Drugs, soap, cosmetics	125.9	98.1	129.1	+ 3	+32	319.7	337.2	+ 5
29	Petroleum prod. and refining	548.0	509.7	626.7	+14	+23	1,627.1	1,711.7	+ 5
39	Cement, glass, & stone	113.0	103.6	94.4	—16	— 9	300.8	261.8	—13
32	Iron and steel	D-131.0	203.2	101.0	+....†	—50	637.4	639.6	+....†
29	Electrical equip., radio & tv	120.2	99.9	100.0	—17	+....†	323.1	301.9	— 7
48	Machinery	108.8	98.4	96.4	—11	— 2	296.3	287.1	— 3
18	Nonferrous metals	47.9	59.7	52.7	+10	—12	191.0	172.6	—10
98	Other metal products	122.3	91.5	94.2	—23	+ 3	319.9	272.0	—15
26	Automobiles & parts	189.1	457.3	152.0	—20	—67	1,228.0	1,132.7	— 8
18	Other transp. equip.	14.0	D-26.2	17.8	+27	+....†	73.3	17.9	—76
60	Misc. manufacturing	122.8	105.0	116.5	— 5	+11	308.2	307.3	—....†
570	Total manufacturing	1,861.6	2,293.8	2,014.0	+ 8	—12	7,067.3	6,823.6	— 3
28	Mining & quarrying	18.7	37.6	29.6	+58	—21	88.4	100.2	+13
36	Trade (retail & wholesale)	48.2	52.2	52.7	+ 9	+ 1	151.8	156.2	+ 3
22	Service & amusement	14.3	15.7	15.4	+ 7	— 2	43.0	45.9	+ 7
50	Railroads	88.7	124.8	66.0	—26	—47	376.9	288.2	—24
60	Electric power, gas, etc.	201.2	223.6	227.6	+13	+ 2	653.9	717.9	+10
3	Telephone & telegraph	298.0	320.4	326.6	+10	+ 2	869.3	947.8	+ 9
764	Total	$2,530.8	$3,068.0	$2,731.9	+ 8	—11	$9,250.6	$9,079.3	— 2

*Per cent changes and totals computed from unrounded data. D - Deficit.
†Increases or decreases of under 0.5% or over 100% not shown.

spreading effects upon other industries, was not especially high.

The profits pinch reflects struggles of business in coping with a new environment of worldwide competition. The existence of spare capacity in practically every industry at home, together with the resurgence of foreign producers in world markets, has weakened prices in many lines and prevented needed increases in others. With markets more and more competitive, discounts from list have become commonplace while sales efforts have had to be intensified. At the same time, wages, taxes, and other cost elements have continued upward about as rapidly as in previous years.

Diverse Trends

While these influences have dominated the earnings picture, the diversity in performance of individual industries has reflected the mixed trends in the economy. Out of 17 manufacturing groups, 11 show declines in earnings from 1959 while six industries scored gains in the first nine months.

The most striking change in fortune was experienced by the steel industry. In contrast to the heavy losses suffered during the steel strike last year, steel producers as a group managed to stay in the black while the industry operated at 52 per cent of capacity in the quarter just ended. Some producers, however, again showed deficits, and earnings over all plummeted 50 per cent from the June quarter.

Earnings of the auto companies have been trimmed by the shift toward compact cars which not only yield smaller profits per car but have required expensive changes in production facilities. Though unit sales ran 8.5 per cent ahead of 1959 in the first nine months, the rise of the compacts together with extensive rebating have reduced earnings of the autos and parts group by 8 per cent this year.

The oil industry, on the other hand, continued to show recovery in the September quarter as prices of most petroleum products remained firm at home and demand improved abroad. Higher domestic sales of petrochemicals and natural gas were reported by several companies. The better results were vitally helped by vigorous efforts to cut costs, including reduction of drilling activity.

Lower selling prices were chiefly responsible for falling earnings among producers of chemicals, electric appliances, man-made fibers, and tires. The decline in homebuilding continued to affect profits among producers of lumber, plywood, glass, plumbing equipment, and other builders' supplies. In cotton textiles, smaller earnings than in the year-ago quarter were caused by reduced output and sales as the industry entered the contracting phase of its inventory cycle. The aircraft and missile companies, despite continuing heavy writeoffs on commercial jet airliners by some makers, managed to show some improvement after a depressed second quarter.

Outside of manufacturing, all of the industry groups except the railroads registered good-sized gains over the year-ago quarter. Most railroads in the East suffered from reduced loadings of industrial goods in the September quarter compared with a year ago, but higher carloadings of grain and ore helped the Western roads.

Retail firms generally matched their results in the June quarter and posted healthy gains over the year-earlier period. Electric, gas, and telephone utilities continued to score year-to-year increases in earnings

The Revised '61 Budget Outlook

On October 4 the Bureau of the Budget released its usual mid-year review of the federal budget for the fiscal year ending June 30, 1961. The report takes account of Congressional actions on the President's original budget proposals presented last January, as well as changes in the revenue outlook. In January, it will be recalled, the President forecast receipts of $84.0 billion and proposed that expenditures be held at a level of $79.8 billion to produce a surplus of $4.2 billion which could be applied to retirement of public debt.

The review shows a narrowing in the projected surplus figure to $1.1 billion; the expenditure figure has been raised by $0.6 billion to $80.4 billion while the estimate of revenues has been pulled down by $2.5 billion to $81.5 billion.

Federal Budget Expenditures and Receipts
(In Billions of Dollars)

Fiscal year	Expenditures	Receipts	Deficit (—) or Surplus (+)
1958	$71.9	$69.1	— 2.8
1959	80.7	68.3	—12.4
1960	77.2	78.4	+ 1.2
1961:			
Jan. est.	79.8	84.0	+ 4.2
Oct. est.	80.4	81.5	+ 1.1

The new revenue figure would represent the largest amount ever collected in a single year by the United States or any other government. The even bigger January estimate had been founded, like many other business forecasts, on excessive expectations of prosperity. The level of 1960 corporate profits before federal income tax had been gauged at a new record of $51 billion in the January budget estimates but the weakening in profit margins, as discussed elsewhere in this *Letter*, has compelled a downward revision to

1959's $47 billion figure. Since the United States Government takes more "dividends" out of corporate profits than anybody else, this implies a reduction in prospective corporate income tax receipts from $23.5 billion to $21.5 billion. Personal income, on the other hand, has held up to expectations and the estimate of individual income tax revenues remains unchanged from the figures put down in January.

The revised expenditure estimates indicate that we are once more breaking through the $80 billion mark this year, closely approaching the $80.7 billion postwar high in fiscal '59 when expenditures jumped $8.8 billion from the preceding fiscal year as a result of the increased spending authorized during the 1958 business recession. Against fiscal '60 outlays, shaved back to $77.2 billion, the $80.4 billion figure now projected for fiscal '61 is up $3.2 billion. Still larger figures loom up if the Congress being elected this month attempts to implement the many promises made in the party platforms and campaign speeches of candidates.

Expenditure Programs

The principal factors enlarging the prospective fiscal '61 expenditure total, as the Budget Bureau's review brings out, are the $746 million pay raise for federal civilian employes, passed over Presidential veto, and the failure by Congress to enact the recommended increase in postal rates to reduce by $554 million the operating deficit of the postal system. The inaction on postal rates accounts for more than half of the $1,086 million rise under the heading of Commerce and Housing. The cost of the pay increase, which took effect last July, is spread among all Government departments. Amounts budgeted for National Security are stepped up $431 million, mainly reflecting additional funds allocated to research and procurement of missiles and Polaris submarines, the Samos reconnaissance satellite, and airborne alert capabilities.

Among the offsets to these increases is a $490 million reduction in estimated interest costs on the federal debt, a result of the decline that has occurred this year in money rates and bond yields. It is worthy of note that this decline was set in motion by the President's proposal last January to hold back expenditures and to allow a rise in revenues to provide funds for debt retirement. The $182 million decrease in projected outlays for Agriculture reflects lower expenditures expected for price supports, surplus disposal, and the soil bank program. Nevertheless, the total remains at an altitude beyond $5 billion, equal to $1,335 per farm family. Estimated expenditures for Veterans Services and Benefits, shaved $145 million from the projection in January, remain another $5 billion item.

Federal Budget Expenditures by Major Functions
Fiscal Year 1961
(In Millions of Dollars)

	Fiscal '61 Current est.	Change from Fiscal '61 Jan. est.	Change from Fiscal '60 Actual
Defense Spending:			
Major National Security	$45,999	+ 431	+ 390
International Affairs and Finance	2,183	− 59	+ 362
Total Defense	$48,182	+ 372	+ 752
"Benefits":			
Commerce and Housing	3,795	+1,086	+1,017
Agriculture	5,441	− 182	+ 593
Natural Resources	2,025	+ 87	+ 312
Labor and Welfare	4,480	− 89	+ 60
Veterans Services and Benefits	5,326	− 145	+ 266
Total "Benefits"	$21,067	+ 757	+2,248
Other Nondefense Spending:			
Interest	9,095	− 490	− 173
General Government	1,991	+ 80	+ 296
Allowance for Contingencies	75	− 125	+ 75
Total Other	$11,161	− 535	+ 198
Total Expenditures	$80,410	+ 594	+3,198

In comparison with actual budget outlays in fiscal '60, spending for National Security is slated to rise $390 million, while expenditures on International Affairs and Finance increase $362 million. Outlays for General Government are expected to advance $296 million. Interest is expected to be $173 million lower, a result of debt retirement as well as cheaper borrowing costs.

Increases over fiscal '60 are forecast for all other categories, adding $2.2 billion to total expenditures over fiscal '60. Spending under these other programs may be broadly described as "Benefits" since they represent Federal Government activities at home for the public welfare, including farm price supports, public assistance programs, the postal deficit, aids to housing, public works projects, and veterans pensions and hospital care — to name a few.

It has been the broad category of "Benefits" which has been the main propellant of the upthrust of federal expenditures in recent years. The outbreak of the Korean war brought a sharp upturn in outlays for defense spending in fiscal '51 and '52, but since that time there has been a doubling of expenditures on "Benefits" while other categories of federal spending have risen less than 10 per cent in the aggregate. A larger and larger share of our tax dollars has been going, not for National Security or International Affairs, but to finance programs of a benefit or welfare nature. Spending for "Benefits" in fiscal '52 constituted 17 per cent of the federal budget; the outlook for fiscal '61 is that over 25 per cent of the total will reflect "Benefits" flowing to the public through the Federal Government.

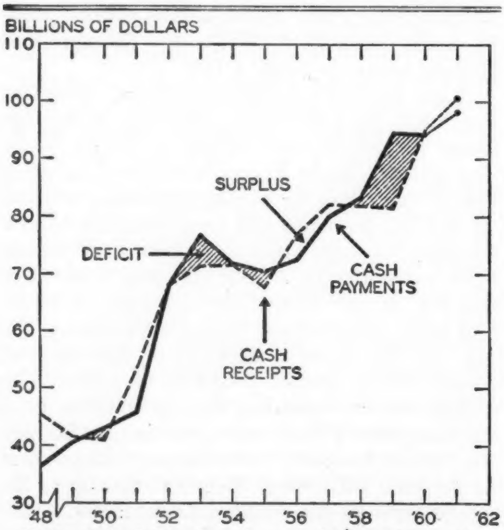
New federal programs, adopted to meet some real or imagined "crisis," tend to live on and

grow as a result of the political pressures of organized beneficiary groups. Once federal aid has been provided, it seems virtually impossible to cut it off. This fact of political life invites sober caution when new programs are considered for adoption by the Congress. Small initial expense is the seductive charm that invites Congressional approval. But each new program requires staffing a new bureau. Each is the seed of a vigorously growing plant. Each dissipates the energies of a Federal Government that needs to focus its attention on important things like national defense and preserving the basic strength of a free society of self-reliant individuals.

The Cash Budget

To an increasing extent with each passing year, the regular budget figures understate the true magnitude of cash flows of funds through the coffers of the United States Treasury. This is because of the growth of trust funds, operating outside the "administrative budget" discussed above. For the first time in American history, total cash receipts of the Federal Government are expected to exceed $100 billion.

The accompanying chart shows the figures for total cash receipts and payments to the public by the Federal Government since 1948. Each year more tax revenues feed into trust funds. For example, payroll taxes, to support the social security program, are being progressively raised as also are the benefits offered. Gasoline taxes earmarked for the highway trust fund, which came into being in 1956 to finance the Interstate Highway System, are projected to bring in $3 billion in fiscal '61. The increase of Federal Government activities handled outside the regular budget makes it imperative to look to the cash budget as the better yardstick of the total impact of Government finance upon the economy.



Federal Cash Receipts from and Cash Payments to the Public, Fiscal Years 1948-61

The record on federal income and outgo contradicts the theory that the main trouble with the American economy is that government is "poverty-stricken" and most urgently needs more money. It is a fact of record that the Federal Government has had a lot of trouble keeping its budget balanced. This has not been for lack of more money coming in but for lack of greater caution in undertaking new commitments.*

"George Government"

As the chart shows, cash spending in fiscal '61 is resuming the rise – interrupted only in fiscal '60 – that began five years ago. An indefinitely continuing increase seems foreshadowed by election campaign promises of more spending for almost every imaginable purpose. If the new Congress, taking office in January, approaches its legislative task with the view to spending more on a broad front, outlays will be bound to extend their growth at least through the fiscal year ending June 30, 1963. As Federal Budget Director Stans pointed out a week ago, "today's promises are tomorrow's taxes." It takes six months to a year or longer before enlarged appropriations have their effect on actual spending. All this on top of automatic, "built-in" increases under existing programs.

In a nonpolitical speech at Houston, Texas, on October 24, President Eisenhower, out of intimate knowledge of the Federal Government machinery, had this thoughtful advice to offer the American people:

> I counsel you to continue to guard jealously the rights reserved to your state under our Constitution – to keep your government close to home, your local affairs out of the hands of a meddlesome, bumbling bureaucracy thousands of miles away.
>
> Weigh carefully the words of those who carelessly say let the Federal Government do it or pay for it. For in the end it is the people – not the government – who pay and they pay not only in money, but in a currency far more precious – their hard-won right to run their own affairs in their own way. This is fundamental.

There is a great tendency these days to let "George Government" do it. This attitude is all the more difficult to resist because the weight of taxes is felt so keenly that citizens come to feel entitled to get from government, free of further cost, services that they could perform better and more economically themselves. The trend is away from the forward looking self-reliance that made the United States the power that it is in the world today.

*See this *Letter* for June, "Private Affluence and Public Poverty."

The big question is whether we are going to pursue the path of more and more spending until we have more taxes than incentive to work. Or are we going to get down to the practical business of reforming our tax system to invite and make possible a better performance of the free enterprise sector which still remains the citadel of our strength. The American people, acting through the representatives they elect this month, will be called upon to make the decision, fateful to the shape and dimensions of our progress in the years to come.

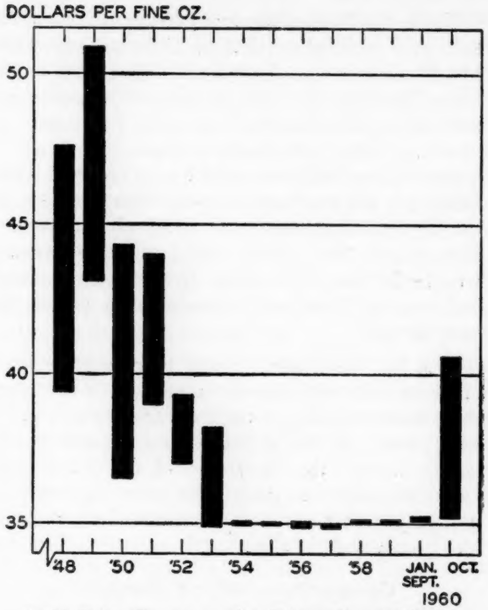
Flare-up in Free Gold Markets

Gold has figured increasingly in the news in recent months. In July, when conventions of both political parties adopted platforms favoring larger federal expenditure, the drain on the U.S. gold stock, which began during the 1958 spending spree, was visibly accelerated and reached a peak in September when the Treasury was called upon to convert $321 million of dollar balances into gold for the account of foreign governments and central banks. Although the gold stock remains at a comfortable level of $18.5 billion, the September loss renewed talk, particularly abroad, about the U.S. balance-of-payments deficit and a possible eventual dollar crisis. Some increase of interest in shares of gold-mining companies became apparent.

In the first three weeks of October, drafts on the U.S. gold stock moderated, but strengthened private demands appeared in free gold markets abroad. In London, beginning in September, the price had inched slightly above its normal trading range, around the U.S. price of $35 per fine ounce, and then, on October 20, suddenly shot up a little beyond $40. After touching $40 again October 24, the price quieted down into a range of $35.75 to $37. The chart shows this flare-up against the background of the orderly narrow range of fluctuations dating back to 1954.

The breakout of the London gold price, paralleled in the free markets of Switzerland and Canada, attracted worldwide attention and raised questions among Americans as to what it could mean. The simplest and truest explanation is that the rise reflects desires of many people to seek a safe haven for their capital in a troubled and uncertain world. Some of them doubtless are Americans. More, perhaps, are foreigners, who either hold dollars or are able to get gold with their own national currencies. The demands fell on a thin market, unprepared to accept sudden increase in activity.

There have been some special factors at work. The pinch on profit margins has reduced the



Gold Price Range on the International Market

For gold bars, normally approximately 400 ounces or 12.4 kilograms. Quotations for 1948-53, Switzerland; thereafter, London.

attractions of investment in American common stocks, leading to shifts of funds abroad. Some of the capital fleeing Cuba and troubled spots in Africa has sought safety in gold. The movements of funds to the Swiss market have led the authorities there to penalize foreign holders of Swiss francs by imposing a charge on "hot money", making gold a more economical store of value. In Germany, with the same effect, payment of interest on foreign deposits has been forbidden.

The More Fundamental Considerations

Beyond these immediate and perhaps transient influences, there are two more fundamental considerations. One of them is the persistence, for a third successive year, of a $3 billion-plus deficit in the U.S. balance of payments. These deficits explain over-rapid accumulation of dollars abroad and conversions of excess dollar balances into gold at the U.S. Treasury by foreign governments and central banks.

Secondly, there are fears, expressed by some Americans and foreigners alike, that a new Administration taking office January 20 next will enlarge government spending and perhaps also seek to impose an artificial cheap money policy. While these things may not come to pass, it is not unnatural that some of the "cheap money" campaign speeches should have aroused fears at home and abroad of a new surge of inflation in the United States.

There has been a tendency to regard the situation as a parallel to that of 28 years ago when Mr. Roosevelt was elected and felt a need to devalue the dollar to raise prices and provide freedom from the discipline of gold upon government spending and credit policies. But this is to ignore critical differences between the two situations: we are not now, as was then the case, in the depths of a deep and seemingly intractable depression. The whole world monetary system was in a state of disorder from which, indeed, full recovery has been achieved only within the past decade.

It is for the United States to recognize what other nations successively have had to do to restore convertibility of their currencies and nourish growth of world trade and capital movements: accept the discipline of the balance of payments and recognize that spending must be limited to what a country can afford in terms of real goods and services.

Compartmentalized Markets

Some people are puzzled by the fact that the gold markets operate on a two-price system. The U.S. Treasury sells and buys gold bars at $35 per fine ounce plus or minus handling charges. There is no free gold market in the United States. We have had a policy, initiated in 1933, of limiting U.S. monetary gold transactions to those with foreign governments, central banks, and international financial institutions. It is this policy which separates the U.S. official market from free gold markets.

The International Monetary Fund, from its beginning in 1947, sought to starve out free gold markets by asking its members to refrain from feeding gold to them. The thought was that transactions in gold at premium prices tended to undermine exchange stability and impair monetary reserves. This line of policy proved unworkable. For example, in France, where people traditionally hold gold as the surest store of value, the government legitimized domestic free markets in 1948, and the authorities found it desirable to deal in these markets to prevent fluctuations that would have disturbed confidence in the paper franc. Russia, the second largest gold producer, could get premium prices in the East, outside IMF jurisdiction; African and other producers sought the same right.

The general effect of the effort to suppress private gold trading was to raise free or black market prices of gold, to $50 and more, and these prices increased leakage into free markets. In 1951, when the IMF amended its policy, the amount of gold supplied for nonmonetary use and private hoarding was larger than in any previous postwar year. The gain in aggregate official gold holdings in 1951 was barely one fourth of new gold production outside Russia.

Since 1952, the bulk of new gold production has been offered on free gold markets, in Zurich prior to the opening of the London market in 1954, and in London and Zurich since that time. The enlarged offerings of new gold on free markets soon saturated private hoarding demands, eliminated the premium (as the chart shows), and sharply reduced the leakage of new gold production into nonmonetary uses and private hoards. In eight years, 1952-59, slightly more than one half of new gold production outside Russia went into official gold holdings.

Abandonment of artificial cheap money policies, around the same time, played an indispensable role in restoring confidence in paper currencies. But the sheer availability of a larger supply of gold in free markets had the effect of reducing demands. Many purchasers at premium prices lost heavily and gold was shorn of much of its appeal, particularly since holding the metal involved not only loss of interest return on funds but also an actual expense of custody.

Two-Price System Re-emerges

Coins, particularly those in mint condition valued by collectors, consistently have maintained premiums over bar gold in which the main business is done. But, ever since 1954, prices of bars have been prevented from falling significantly below the $35 price only because governments and central banks (including at times the U.S. Treasury) have automatically bought at that level to replenish or enlarge their reserves. For six years the two-price system disappeared from public view.

Foreign central banks and governments are entitled to obtain gold from the U.S. Treasury at the official selling price of $35.0875 "for the settlement of international balances or for other legitimate monetary purposes." Official quarters, thus, naturally dropped out as buyers in the free markets when the price shot up. Thus the technical significance of the events of October was that private demands were big enough to take up all offerings of newly-mined gold. The two-price system has at least temporarily reemerged.

It has been asked why treasuries and central banks have not acted, through offerings from their official reserves, to prevent the price run-up. Although the Bank of England is understood to have offered some gold late in October to calm the market, it should be understood that

European central banks have no responsibility to hold down the price when private demands mount. It has been against U.S. policy to sell gold in free markets and to meet speculative or hoarding demands for the metal. Yet the practical fact is that the flare-up, and all the associated excitement, would not have occurred if some holder with a sizable stock had offered some tens of millions on the London market.

The broad question arises as to whether the United States Government should not permit the opening of a free gold market, paralleling those in European financial centers, or at least soberly reconsider whether the policy of ignoring free gold markets, adopted a quarter-century ago, is appropriate and realistic.

The episode, in any case, has served a useful purpose. It has signaled the alertness of people all over the world to the inflationary hazards in politically popular efforts to spend ourselves rich. The political and economic stability of the Western World cannot sustain experimentation along this line. As President Franklin D. Roosevelt once said:

> Too often in recent history liberal governments have been wrecked on rocks of loose fiscal policy. We must avoid this danger.

The Dollar In the World Today

A month ago, finance ministers and central bankers from 68 countries gathered in Washington for the fifteenth annual meetings of the International Monetary Fund and World Bank. The dominant impression that emerged from the quiet, undramatic sessions was that the world payments structure has continued to strengthen markedly over the past year. Today, an overwhelming part of world trade is settled in currencies that are either fully convertible or, like the pound, convertible for foreign holders. Substantial progress has been made toward eliminating direct quantitative restrictions on imports, especially in relation to the dollar area.

Looking back, the Fund's Managing Director, Dr. Per Jacobsson, noted: "It is no mean achievement to have almost doubled in a decade the volume of world trade, and to have established an effective international payments and credit system based on convertible currencies."

While the assembled officials agreed that the international payments situation is healthier than only a few years ago, many of them expressed concern over the sizable and persistent deficit in the balance of payments of the United States and its counterpart – the payments surplus of Western Europe.

The Renewed Outflow of Gold From the U.S.

Increasing the economic vigor of the Free World has been a primary objective of the United States since World War II. To finance reconstruction and development, and also – since 1950 – with an eye on Russian imperialism, the United States has supplied huge amounts of dollars to nations abroad. These dollar flows first relieved – and then reversed – the postwar "dollar shortage." Over the past decade, foreign countries, having corrected in 1949 the overvaluation of their exchange rates, have succeeded in raising output and productivity and in restoring fiscal and monetary order. As a result, the dollars supplied by the United States have enabled much of the world to rebuild monetary reserves and gradually to restore convertibility and multilateral trading.

Over the past three years, however, the build-up of monetary reserves abroad has entailed balance-of-payments deficits that the United States cannot afford to run indefinitely – beyond $3 billion a year. The deficit this year may not fall much short of last year's $3.8 billion.

The deficit is settled by transfers of gold and dollars to foreign nations. In 1958, foreign nations used approximately two thirds of their newly acquired dollars to buy gold from the United States and added most of the remainder to their income-earning liquid dollar assets. Last year, and indeed through June of this year, they took much less gold. More recently, however, they have stepped up gold conversions, as evidenced by the $849 million drop in the U.S. Treasury's gold stock from July 1 to October 26.

This gold and dollar outflow does not stem from a trade deficit. This year, the surplus of our commercial merchandise exports over imports has been running at an annual rate of $4 billion, exceeded in the past decade only during the Suez crisis in 1956 and 1957; in 1959, the surplus was down to $0.9 billion. The recovery has been sharp and dramatic.

While imports have been running nearly on a par with the 1959 level of $15.3 billion, commercial exports have moved up from 1959's $16.2 billion to a rate rivaling the 1957 peak of $19.4 billion. Admittedly, the export performance this year reflects some special factors. Although practically all commodity groups shared in the general export rise, the sharp – and perhaps transient – expansion in shipments of cotton and aircraft accounted for two fifths of the total increase. Nearly three fourths of the rise in exports this year went to Europe and Japan where booming conditions have not only stimulated demands for American goods but have also hampered abilities to deliver to other markets.

U.S. Balance of Payments
(In Billions of Dollars)

	Average 1951-56	1957	1958	1959	1960*
Merchandise exports†	$14.0	$19.4	$16.3	$16.2	$19.1
Merchandise imports	—11.3	—13.3	—13.0	—15.3	—15.1
Trade surplus	2.7	6.1	3.3	0.9	4.0
Services rendered	5.3	7.3	7.1	7.2	7.3
Services received‡	—3.8	—5.2	—5.4	—5.9	—6.4
Service acct. surplus‡	1.4	2.2	1.7	1.3	0.9
Surplus on trade and services†‡	4.2	8.3	5.0	2.2	4.9
U.S. Government transfers					
Military expenditures	—2.4	—3.2	—3.4	—3.1	—2.9
Economic grants	—2.0	—1.6	—1.6	—1.6	—1.7
Loans and credits (net)	—0.3	—1.0	—1.0	—0.4§	—1.1
Subtotal	—4.6	—5.7	—6.0	—5.1§	—5.7
Private capital outflow	—1.4	—3.2	—2.8	—2.3	—2.8
Private capital inflow	0.3	0.4	0.0	0.5	0.7
Net private capital	—1.1	—2.8	—2.8	—1.8	—2.1
Total government and private transfers	—5.8	—8.6	—8.8	—6.8§	—7.8
Excess of transfers over surplus on trade and services	1.6	0.3	3.9	4.6§	2.9
Settled by:					
Gold sales to foreigners	0.1	—0.8	2.3	0.7§	1.1
Increase in foreign short-term assets	1.1	0.4	1.2	2.4§	2.4
Increase in foreign holdings of U.S. Government bonds	0.0	—0.1	0.0	0.7	0.1
Foreign capital and gold	1.2	—0.5	3.5	3.8§	3.6
Unrecorded payments (errors and omissions)	0.4	0.7	0.4	0.8	—0.7

*Estimates for first nine months raised to an annual basis (without seasonal adjustment).
†Excluding military aid programs.
‡Including private remittances and government pensions; excluding military expenditures abroad.
§Excluding additional U.S. capital subscription to the International Monetary Fund, of which $344 million in gold and $1,031 million in nonnegotiable non-interest bearing demand notes of the U.S. Treasury.
Source: U.S. Department of Commerce, except 1960 which is estimated.

The current-account surplus is, however, more than offset by U.S. Government outlays abroad and private capital outflows. In recent years, government transfers abroad -- military expenditures, economic aid, and loans — have been running between $5 and $6 billion annually.

Capital Flows

Private capital outflows are currently at a rate beyond 1959's $2.3 billion. Since midyear, the capital outflow, normally of a long-term investment character, has been enlarged by movements of short-term funds to European financial centers. Some of this outflow appears, statistically, in the so-called "errors and omissions"; while in 1959 this item implied unrecorded capital inflows, this year it signals capital outflows.

These short-term capital outflows reflect a variety of factors. Most important — and least worrisome — has been the new respect earned for European currencies which has made short-term capital sensitive to interest differentials between major centers. Because of differences in inflationary pressures — weakening here and strengthening abroad — short-term interest rates in the United States have fallen by about 2 per cent this year while in Germany and the United Kingdom they have risen by some 2 per cent. Even allowing for the cost of covering the exchange risk, interest arbitrage has been profitable. As interest rate relationships change, this money may come back. In any case, American money going abroad has its counterpart in the acquisition of foreign assets, whether short-term money market instruments or long-term investments in productive enterprises.

Of less quantitative importance — but of greater potential concern — is an element of speculation that the dollar may be heading for a devaluation, as discussed in the preceding article.

In the outflow, we have something like a cat chasing its own tail. People are moving funds abroad because of the balance-of-payments deficit, and it is this very outflow of funds which is enlarging that deficit.

There *is* a fundamental weakness in the U.S. balance of payments. It is neither on trade nor private capital account: it is on account of the vast overseas commitments of the U.S. Government. We have plenty of flexibility to absorb ebbs and flows of short-term capital as well as to continue the long-standing policy of encouraging exports of U.S. capital and know-how.

Europe's Surplus

The counterpart of the U.S. balance-of-payments deficit is, as already noted, Europe's surplus (and, to some extent, also Japan's). There has been a strong and persistent flow of reserves into Europe. The rise in reserves would have been even more striking had not various countries repaid large amounts of debts to the United States and the International Monetary Fund, sometimes in advance of maturity.

In the United Kingdom, the rise in reserves reflects primarily the inflow of short-term funds, taking advantage of the attractive yield on British Treasury bills — beyond 5 per cent since mid-June. British merchandise trade, as usual, shows a deficit; the surplus on "services", such as freight, income from foreign investments, etc., is not currently large enough to offset the merchandise deficit. The rise in reserves has thus been counterbalanced by an increase in foreign sterling liabilities. On October 27, the Bank of England's discount rate was cut from 6 to 5½ per cent. It was explained that the 6 per cent rate appeared "unduly high in relation to rates overseas."

On the Continent, the rise in reserves stems partly from current-account surpluses, partly from short-term capital inflows. Germany, with the largest increase in reserves in the past year, has had an export surplus over the past three years

averaging $1.3 billion annually. This year, however, the rise in reserves has been due increasingly to capital inflows induced both by speculation on an upward revaluation of the mark and by higher interest rates established to counter inflationary pressures in an "overheated" economy. The German authorities have stated that no mark revaluation is intended, and have taken a number of steps to discourage inflows of funds.

France and Italy have also added substantially to their gold and foreign exchange reserves. In France, the discount rate was reduced on October 6 from 4 to 3½ per cent.

Many of the industrial nations of Western Europe have surpluses not only with the United States but also with the less-developed parts of the world. The size and the persistence of overall surpluses and deficits are, in Secretary Anderson's words, "a most important, indeed a crucial, problem now facing us in world finance."

One important means of adjustment for the surplus nations is to open their markets wider to imports, giving other nations, through exports, fair opportunity to pay for what they want to buy. Removal of the special turnover tax on German imports, now under discussion, is a case in point.

Another urgent need is to adapt our economic aid and military commitments, which grew out of the circumstances of the 1950's, to the new situation in the world economy and finance. Now that Western European nations are much stronger, they are increasingly able to contribute funds for common defense and for economic aid to the less-developed parts of the world.

Many influential spokesmen at the Fund and Bank meetings urged Germany to provide more development capital. It already provides Government guaranties for private loans abroad, and the Bundesbank has extended loans totaling about $600 million to the World Bank (including $240 million last July); but so far little foreign aid has been extended directly by the Federal Government. As Economics Minister Ludwig Erhard pointed out, the yardstick for potential capital exports is "not the amount of the German monetary reserves but only Germany's capacity to raise funds." At the moment, plans for raising substantial amounts to finance development abroad are being carried out by the private economy and the Government.

The Dollar in Perspective

Viewed in world perspective, the dollar remains a strong and desirable currency. But other currencies, backed by productive economies and large monetary reserves, have also grown strong and become increasingly desirable.

Even now, after the transfer of $6 billion of gold to the rest of the world since the end of 1949, the U.S. gold reserve — $18.5 billion on October 26—is large. The United States still holds some 45 per cent of the monetary gold stocks of the Free World. In 1949, when our gold reserve stood at its peak, the United States held two thirds of the world's stocks; in 1938, it held approximately one half and in 1914 somewhat less than one fourth.

The United States holds considerable short-term assets abroad. Our private long-term investments abroad exceed the long-term investments of foreigners in our own country by over $28 billion. The U.S. Government holds foreign government obligations some of which could be repaid more rapidly, as has been done in the past two years. In fact, year after year our new investment abroad, governmental and private, is larger than the combined increase in our short-term indebtedness to foreigners and our gold loss.

Yet, the United States, in its role as the biggest international banker, is a heavy debtor on short-term account. Last August our foreign short-term liabilities amounted to $17.8 billion.

We must be watchful of our international solvency and sensitive to any weakening of confidence in the U.S. dollar as a standard of value equivalent to gold and the common denominator in international trade and financial settlements.

The United States, therefore, needs a comfortable gold reserve. An ample gold reserve gives time to adjust commitments abroad to what our merchandise trade surplus can afford. It also gives U.S. authorities a measure of latitude in using monetary and fiscal policies to deal with a business recession.

But, as concluded in our May 1960 *Letter:*

> . . . it is clear that we will need to exercise more discretion than at some times in the past in the use of economic stimulants. Specifically, we can no longer afford to carry cheap money to extremes or let go the reins on government spending. . . . We need to find fiscal policies, such as tax reforms, which can check recessions and stimulate creative effort and growth without opening the floodgates to inflation.

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